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Agenda Item 4b

October 18, 2011

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

- I. **SUBJECT:** Proposed Regulations Regarding Personal Trading
- II. **PROGRAM:** Enterprise Compliance
- III. **RECOMMENDATION:** Staff recommends Board approval of the Personal Trading Policy (Attachment A) as a first reading and approval of the proposed regulation (Attachment B) and initiation of the rulemaking process to add Section 558.1 to Title 2 of the California Code of Regulations to establish requirements for personal trading.

IV. ANALYSIS:

State law prohibits CalPERS staff from using confidential information available to them by virtue of their employment for private gain or advantage. In addition, as fiduciaries, CalPERS staff owe paramount loyalty to CalPERS members and beneficiaries and have a duty to place the interests of those members and beneficiaries first. CalPERS employees may come into possession of, or have access to, material non-public information and have a duty to safeguard this information and to not disclose it. The anti-fraud provisions of the federal securities laws generally prohibit persons who have a duty not to disclose material non-public information from trading securities based on such information. Persons who violate these rules are subject to potential civil damages and criminal penalties. Current industry best practices require the implementation of policies and procedures to ensure that the personal trading activities of employees are reported, monitored, and in some instances, preapproved.

Consistent with best practices in the securities and pension industries, staff is recommending the Board approval of the Personal Trading Policy ("Policy") set forth in Attachment A, as a first reading. Staff also recommends the Board approve staff initiating the rulemaking process to adopt the Policy as a regulation. The regulation is attached as Attachment B. The Policy is designed to help prevent insider trading and front running, avoid conflicts of interest and help ensure that CalPERS employees are complying with federal securities laws and meeting their fiduciary duty to CalPERS and its members.

In 2008, CalPERS implemented a personal trading policy. However, the policy was challenged as an underground regulation and was met with significant opposition from CalPERS staff. The policy was therefore suspended after less than a year. Drawing upon lessons learned in 2008, in developing the current Policy, the Office of Enterprise Compliance worked with staff from the Investment Office, the Legal Office and Human Resources Division. The personal trading policies of other pension funds and financial services firms were examined and many elements of those policies were incorporated to assure adherence to current industry best practices. In addition, staff has initiated a comprehensive communication plan to ensure that affected employees, labor groups, and legislative staff are informed and involved in the process of implementing the Policy. Over the past two weeks, we have held meetings with over 350 CalPERS employees who are covered by the Policy in order to provide them with details about the Policy and implementation plan and to address any questions they had about the Policy. The Policy was revised subsequent to those meetings to reflect many of the comments we received. In addition, the rulemaking process will provide further opportunity for feedback and comment. Throughout the process so far, staff has seen strong support for the Policy from leadership throughout the enterprise.

The Policy and regulation:

- Identify the persons, accounts and investment transactions/securities covered by the Policy.
- Require the usage of designated brokerages.
- Require reporting of covered accounts.
- Establish a pre-trade approval process (available on-line for publicly traded securities) and the process for obtaining reconsideration of denials.
- Specify a 30 day holding period for investments.
- Prohibit transactions during the three day “blackout period” that is one day before and one day after CalPERS executes a trade in the same security; however, the blackout period does not apply to CalPERS transactions through an indexed (passively managed) fund.
- Prohibit personal investments based on confidential information that an employee learns by virtue of his or her employment with CalPERS.
- Prohibit trading “in front” of CalPERS (front running).
- Prohibit transactions in securities while they are listed on the CalPERS Restricted Securities List.
- Restate the rule against trading based on material non-public information.

Approval of the proposed Policy and regulation will:

- Increase compliance with applicable laws and regulations governing personal securities trading.
- Enable the organization to provide an effective platform to monitor trading activity of persons covered by the Policy.
- Help prevent insider trading, front running, and conflicts of interest.
- Ensure CalPERS employees are meeting their fiduciary duty.
- Protect staff from inadvertently violating securities laws and entering into potential conflicts of interest.
- Provide employees with easy 24/7 access to clear trades of publicly traded securities.
- Reinforce CalPERS reputation for integrity by avoiding even the appearance of impropriety.

If Board approval is received, the following regulatory process is planned:

- Publication of the Notice of Proposed Regulatory Action in the California Regulatory Notice Register;
- A minimum 45 day public written comment period (with additional public comment periods as necessary);
- A public hearing, if requested by a member of the public;
- Final Board approval to adopt the regulation; and
- Transmission to the Office of Administrative Law for filing with the Secretary of State and publication in the California Code of Regulations.

Section 558.1 would become effective 30 days after filing with the Secretary of State.

V. RISKS:

Changes to enterprise policy and regulations inherently involve a high degree of risk. Approval of the Policy could potentially result in an adverse impact to recruitment and retention of covered staff, and implementation efforts will require IT support.

If approved, the effectiveness of the Policy could be impacted by several factors, including staff support of the policy, IT capacity to implement software, and implementation costs. Based on feedback from affected staff received during the development of the Policy and an initial analysis of monitoring platforms, the Compliance Office believes these risks to be adequately mitigated.

Failure to implement the Policy would constitute a significant weakness in CalPERS internal controls. Inability to monitor personal securities trading could

result not only in compliance violations and associated legal impacts, but also in significant harm to CalPERS reputation for integrity and fiduciary responsibility.

Approval of this item is expected to result in a reduction to risk exposures for Policy Compliance, Compliance with Laws and Regulations, and Stakeholder Perception, and possible increases in risk exposure for Human Resources Management and Technology/Systems Management.

VI. STRATEGIC PLAN:

This item supports Objective 3.3 of the 2011-12 Business Plan, which states, "Integrate enterprise risk management into governance structures and culture to effectively evaluate, monitor, and manage risk across the organization."

VII. RESULTS/COSTS:

Costs associated with this item have been allocated as part of the Fiscal Year 2011-12 Budget.

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